vescore
by Vontobel Asset Management

Global Market Outlook

What our models are signaling while fears of recession plague market players

July 2022

Current topic: Commodities rally over already?

Asset Management

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At a glance

- Equities:
  Even more underweighted
- Government bonds:
  Duration reduced considerably
- Risk environment:
  Still strained
- Current topic:
  Commodities rally over already?

Plagued by fears of recession

At mid-year, sentiment on global financial markets remains strained. Fears of a recession are mounting in light of runaway inflation and the decisive fight against it by central banks via interest rate hikes. Meanwhile, investors are keeping an eye on earnings expectations and companies' refinancing environment.

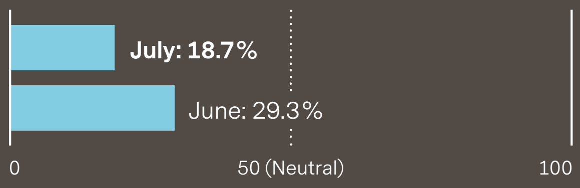
At the start of June already, market player sentiment was dominated by fears that the interest rate hikes announced by the US Federal Reserve would push the economy into a recession. In May, inflation had climbed to 8.6% versus the previous year, the highest figure in 40 years. In response, the US Fed raised rates by a substantial 75 basis points to 1.50 – 1.75% and hinted at the prospect of further rate hikes to bring inflation down towards the 2% target. Astounding inflation data in the eurozone also prompted the European Central Bank to make the turnaround in its monetary policy. As expected, it announced the end of net bond purchases as of July 1 and an interest rate increase by 25 basis points for its next meeting in July. The Swiss National Bank and the Bank of England also announced interest rate hikes to counteract high inflation rates.

This monetary policy tightening on both sides of the Atlantic triggered substantial price losses on international markets in the first half of June. To the surprise of market players, US stock exchanges then experienced a temporary recovery in the middle of the month as published macrodata were weaker than expected and implied that the Fed might therefore adopt a somewhat less rigorous interest rate trajectory.

In the second half of the year, market players look likely to focus on companies and their growth and earnings prospects. Rising interest rates are making companies' refinancing environment more expensive, while there are still numerous obstacles for global supply chains on account of China's Covid-19 policy, transport problems, and significantly higher energy prices.

Equities

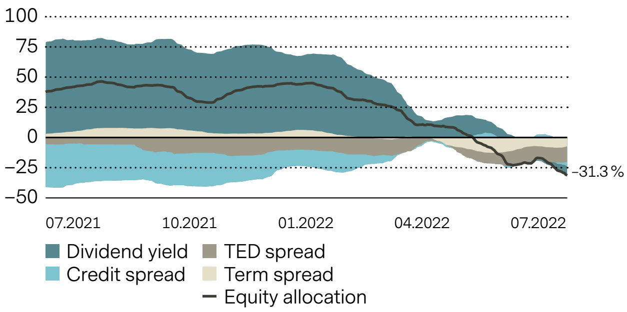
Even more underweighted



At the start of July, the equity allocation in the global GLOCAP sample portfolio (50% equities, 50% cash) is -31.3% versus -20.7% in June. The increase in the underweighting is due primarily to the two microeconomic instrumental variables, dividend yield and credit spread, whose contributions slipped further into minus territory: the former fell by 7.2 percentage points to -7.7% and the latter by 3.5 percentage points to -3.6%. The contributions of the two macroeconomic variables, term spread and TED spread, moved by 0.8 percentage points each in opposite directions, mutually canceling their effect on equity allocation: the former at -7.3% was closer towards positive territory and the latter at -12.7% even further into negative territory than in June. All four contributions being negative implies further gloom on equity markets, which are still nervous about inflation and related central bank announcements. While the US and the UK are already in a cycle of interest rate hikes, the European Central Bank did not provide greater detail about upcoming rate changes until its June meeting. Thereafter, equity prices fell, in some cases markedly, until mid-month, recovering only slightly afterwards. With a few exceptions such as Japan, central banks are tightening their monetary policy. Liquidity supply on financial markets is thus petering out – as demonstrated by the rising TED spread, which is currently the strongest contributor to equity underweighting out of the four instrumental variables of the GLOCAP model.

Chart 1: Equity allocation declined further

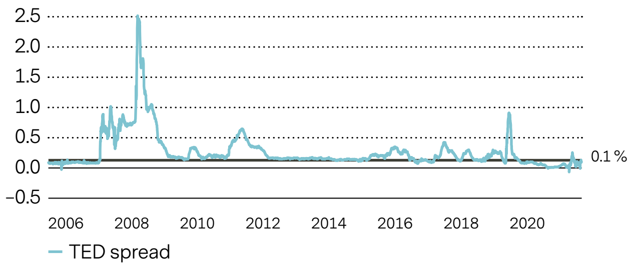
Over-/underweighting (%)



The chart shows the active equity weighting (black line) of a global portfolio in euros, based on a neutral allocation of 50% equities and 50% cash. Foreign currencies are hedged. It also shows the contributions of the individual driving forces (term spread, TED spread, credit spread, and dividend yield), which come together to give the active equity allocation. Information as of July 04, 2022. Source: Vontobel Asset Management

Chart 2: TED spread clearest indicator of short positioning

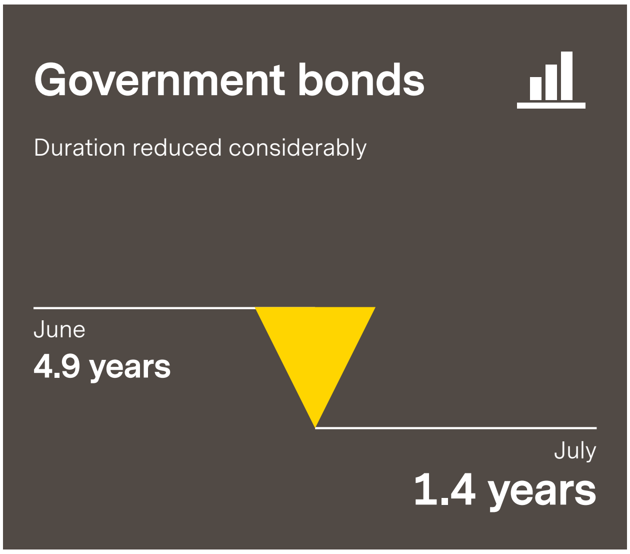
In %



The chart shows the TED spread, which reflects the stability of the financial system in line with the aggregate liquidity preferences of market participants. It is measured by the difference between the interbank interest rates for short-term loans in US dollars and euros and the respective 3-month overnight index swap rate. The chart shows the weighted average (blue line) and the median (horizontal black line) of the instrumental variable. Information as of July 04, 2022. Source: Vontobel Asset Management

	JULY 4	JUNE 2
Equity weighting	**-31.3%**	**–20.7%**
Contribution of the term spread	-7.3%	–8.1%
Contribution of the TED spread	-12.7%	–11.9%
Contribution of the credit spread	-3.6%	–0.1%
Contribution of the dividend yield	-7.7%	–0.5%

The table shows the contributions of the instrumental variables to the equity weighting. Information as of July 4, 2022.
Source: Vontobel Asset Management



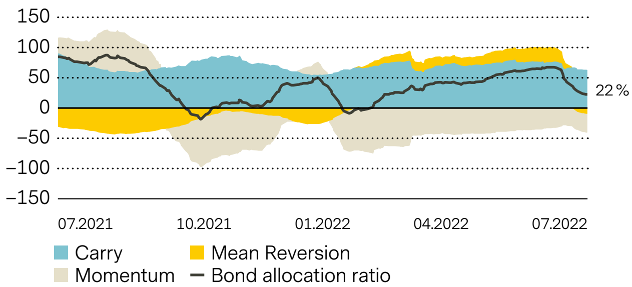
At the start of July, the allocation ratio of a global bond portfolio, which comprises the contributions of the carry, mean reversion and momentum components, is 22 %, far lower than the previous month's 65 %. Duration thus declined by 3.5 to 1.4 years. The main cause of the reduced long positioning is the contribution from the mean reversion component, which collapsed from 25 % to -9 %. Meanwhile, the positive contribution of the carry component decreased from 74 % to 62 %, and the negative contribution of the momentum component weakened from -34 % to -31 %.

In June, volatility on bond markets remained high. With US inflation surprisingly high and the European Central Bank (ECB) now officially announcing a change of eurozone interest rate policy at its meeting, an abrupt sell-off again set in on bond markets, combined with a dramatic widening of government bond spreads within the eurozone. The latter prompted the ECB to call an urgent emergency meeting, where it resolved to take a more flexible approach to reinvesting expiring bonds from the PEPP program and to develop an anti-fragmentation instrument. Calm returned to markets immediately and government bond spreads within the eurozone narrowed again.

In the second half of June, increasing fears of a recession ran rampant, with investors increasingly seeking refuge in government bonds as a safe haven. Although their prices have now recovered well from their low, this countermovement was not enough to close the month in positive territory. The 10-year futures observed within the bond portfolio closed the month at between -2.4 % (Canada) and -0.5 % (Japan).

Chart 3: Mean reversion component dominates

Bond allocation (%)



The chart shows the government bond ratio of a global bond portfolio in euros. The model allocation is calculated by means of the short-term forecast models carry, mean reversion, and momentum. Information as of July 04, 2022.
Source: Vontobel Asset Management

BOND ALLOCATION	TOTAL	CARRY CONTRIBUTION	MEAN REVERSION CONTRIBUTION	MOMENTUM CONTRIBUTION
Global	**22%**	**62%**	**-9%**	**-31%**
Germany	-10%	5%	-10%	-5%
France	-6%	8%	-9%	-5%
Italy	7%	6%	4%	-3%
Great Britain	-3%	3%	-3%	-3%
US	-5%	1%	-3%	-3%
Canada	-4%	3%	-3%	-3%
Australia	4%	6%	1%	-3%
Japan	37%	30%	14%	-7%

The table shows the government bond ratio of a global euro-denominated portfolio and the contributions of the short-term forecast models carry, mean reversion, and momentum to this, in total (row "Global") and by country. Information as of July 04, 2022.
Source: Vontobel Asset Management

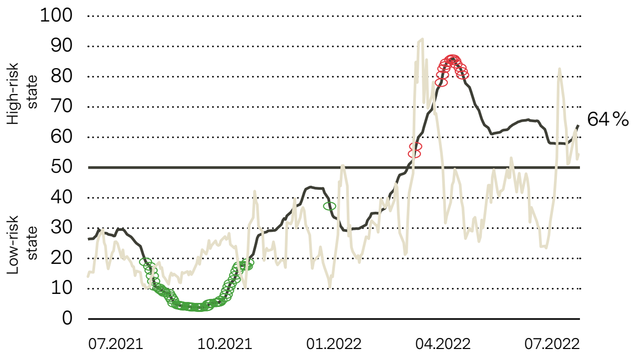
The risk indicator assesses the current market environment and the probability of a future high-risk state on capital markets. It does this by comparing short-term and long-term yields on equity, bond, and currency markets.

At the start of July, the probability of a future high-risk state in developed markets is 64%, slightly lower than the previous month's 65%, but trending upwards at present. In this context, the risk indicator for equity markets rose from 12% to 20%, whereas the indicator for currency markets declined from 88% to 76%, and the figure for bond markets was unchanged at the very high level of 96%. Worries about further inflation and interest rate development and the impact of this on the global economy continue to dominate the market environment, while the geopolitical situation still looks ominous in light of the war in Ukraine. At the start of July, Ukraine announced its withdrawal from the highly contested Luhansk region in the east of the country.

In emerging markets, the aggregate probability of a future high-risk state declined to 34% versus 40% in the previous month, while the risk indicator for currency markets fell from 27% to 12% and the one for bond markets from 92% to 87%. By contrast, the risk indicator for equity markets rose slightly from 2% to 3%.

Chart 4: Upward trend at present

Probability (%)



— Risk indicator
— Market movement indicator
○ Value less than 20% or sharp drop
○ Value greater than 80% or steep increase

The chart shows aggregate probability of a high-risk state in the near future for developed markets (black line), as determined by the corresponding probabilities of the three segments equities, bonds, and currencies. Particularly calm market conditions are marked in green, particularly turbulent ones in red. The uninformed assessment of the future market environment is plotted at 50% (horizontal black line). In addition, the chart shows the aggregate indicator of materialized market movements in the three segments (light gray line). Information as of July 04, 2022. Source: Vontobel Asset Management

Current topic

Commodities rally over already?

Recession would hurt commodities
The Bloomberg Commodity Index (BCOM) soared to its highest level in more than eight years in early June. However, the basket of commodities corrected again over the course of the month, tumbling by more than 11% within two weeks. Yet even after this major sell-off, commodities are still ahead of all other asset classes, up 24% since the start of the year as of June 29, 2022. Nonetheless, investors are now asking themselves: "Was that the end of the commodities super cycle?" Fears of recession have been the dominant issue for several weeks now. In a recession, commodities suffer as a result of subdued demand. However, current demand for commodities still outstrips the reduced supply and no global recession is yet in sight.

Why the significant correction?
There is no clear cause that explains the simultaneous collapse in the prices of grains, industrial metals, and energy sources, as there is still a widespread shortage of commodities and inventories are in extremely short supply. This shortage is also still clearly reflected in positive roll yields. In some cases, such as crude oil, backwardation futures curves have actually become even steeper recently. Considering that fundamentals are still solid, the price losses are likely more a result of many investors liquidating their commodities positions. Reports suggest that some hedge fund managers took significant profits that they generated from commodities long positions in the last year and a half, while other investors had to bid farewell to what has been the strongest asset class so far this year so that they could use the proceeds to cover margin requirements as well as losses incurred by equities and bonds. The pervasive tension created by highly restrictive central banks also did not help. Accordingly, the positions were liquidated on a market where liquidity has been limited for the last few months, further exacerbating the fall in prices.

Central banks cannot print commodities
Record-low inventories mean that commodities markets are currently vulnerable to even the tiniest supply disruption, and so they are extremely volatile. Central banks cannot eliminate the supply problems—not even if they were to trigger a recession in their efforts to tackle inflation, thereby curbing demand for commodities and reducing prices. This is because producers could further delay their already low levels of investment in capacity and future growth to protect against a recession, which would prolong the structural undercapacity seen in the last few years.

Governments annul the effect of higher prices
Moreover, supply and demand on commodities markets will be unable to return to equilibrium under current global fiscal policy. As long as governments provide fuel discounts, subsidize food, and protect consumers against high electricity and heating costs, demand will not decline. China's fiscal and monetary policy is also having a countercyclical effect at present. Given this, a global synchronous recession seems unlikely. As long as demand remains robust and producers continue to underinvest, the price pressure on commodities will likely remain high.

Our models and indicators

GLOCAP	GLOCAP (Global Conditional Asset Pricing) is our proprietary equity allocation model. Active deviations from the neutral positioning (50% cash, 50% equities) are entered into on the basis of an assessment of the economic environment. The long-term economic expectations (term spread), the stability of the financial system and the liquidity preferences (TED spread), market participants' trust in corporations (credit spread), and the fundamental equity market valuation (dividend yield) are evaluated and quantified. The sum of the contributions of these indicators reflects the active equity over- or underweighting. The term spread is measured by the difference between the long-term and short-term interest rates of the major industrialized countries. The TED spread is measured by the difference between the interbank interest rates for short-term loans in US dollars and euros and the respective 3-month Overnight Index Swap rate. The credit spread is measured by the risk premia of corporate bonds with lower ratings versus top-rated ones. The dividend yield is measured by the aggregated ratio of dividend to price on the global equity markets.
FINCA	FINCA (Fixed Income Allocator) is our proprietary bond allocation model. The bond allocation is based on the FINCA multi-model approach, which is used as a tool for forecasting changes in the world's most important yield curves of government bonds and swaps. Short-term forecast models (carry, mean reversion, and momentum) are analyzed for each currency. The resulting allocation is then adjusted to economic conditions. Carry models optimally gear the portfolio dynamically to the expected carry in the respective currency. The carry results from the daily shortening of the term of a bond in combination with an interest rate change, assuming a constant or only slightly changing yield curve. Mean reversion models are aligned to the convergence of interest rates toward a long-term equilibrium. This convergence can be rationalized based on the economic cycle or central banks' countercyclical setting of interest rates. Momentum models follow trends and in particular exploit quick changes in interest rates after political decisions or central bank announcements.
Risk Indicator	Our proprietary Risk Indicator acts in conjunction with our equity and bond allocation models GLOCAP and FINCA as a "second referee" to recognize quickly whether capital markets are in risk-on or risk-off mode. It works based on non-predictive information and uses the stability of the co-variance matrices for three asset classes: equities, bonds, and currencies. Up to 20 different developed markets are included for each asset class. Comparing the short- and long-term covariance, the Risk Indicator classifies markets as "low risk" or "high risk" and thereby identifies changes of the market regime. It responds fast to changes in international financial markets while simultaneously showing high persistence. A probability of 50% reflects an uninformed, non-predictive assessment of the future market environment. When the Risk Indicator anticipates a low-risk, low-volatility environment (value below 50%), it increases portfolio exposure to equity and bond strategies. When it anticipates a high-risk, high-volatility environment (value above 50%), it reduces such exposure. The Risk Indicator's active response should protect investors particularly in periods of market stress by limiting drawdowns.

Using the models and indicators described above we pursue a quantitative investment approach based on financial market research with the aim of achieving an attractive risk-adjusted performance in the long term.

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